

Private Equity Fund Restructurings: Due Diligence, Sponsor Fiduciary Concerns, Key Deal Points for New Investors

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Private Equity Fund Restructuring

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Overview -- Definition

■ What are Fund Restructurings?

- Sub-set of the secondary fund transactions market
- Typically initiated by the fund sponsor as opposed to a selling limited partner
- New investors are brought in to provide existing limited partners with a 100% liquidity **option**
- Fund sponsor continues to manage the fund investments
- Often new investors commit to additional follow-on investment capital and/or new investment capital.

Overview – Why do they happen?

■ Originally began as solution for “Zombie Funds”

- These are funds beyond end of their term
- Sponsor not able to raise a successor fund due to
 - Poor performance
 - Succession issues
 - Internal discord
- As a result – misalignment of interest – sponsor not motivated to sell assets

■ Market has evolved

- Becoming a more acceptable solution:
 - For tail-end funds where sponsors have a high conviction on remaining assets
 - As an exit solution for difficult to sell assets
 - As a means for continued management of stabilized/income producing assets
 - As a liquidity option on a subset of investments (e.g., “strip sale”)

Overview – Some Statistics

- Four out of five LPs believe that GP-led restructuring transactions are set to become a “routine” part of the PE landscape (Coller Capital Global Private Equity Barometer, 2018)
- GP-led restructurings represented fully one-third of all secondary transaction volume in 2017 (Credit Suisse data, Transaction Advisors) and 98% of survey respondents among secondary market participants expected to spend as much or more time on GP-led transactions going forward (Campbell Lutyens Q1 2018 survey data)
- As of Q1 2018, “zombie” private equity funds are sitting on @\$140 billion worth of unrealized investments (Preqin)
- There was over \$80 billion in dedicated “dry powder” available as of Q1 2018 in the hands of secondary buyers (Campbell Lutyens)

How Does the Process Work?

- Typically initiated by the fund sponsor
 - Will retain an intermediary to facilitate bidding process, investor communications, etc.
- Significant investor participation
 - Initial investor outreach
 - LPAC and/or investor approvals required
- Extensive due diligence required (sponsor and buyer):
 - Portfolio company analysis: bank debt, regulatory issues, employee compensation matters, stockholder agreements, commercial contracts, etc.
 - Tax Considerations
 - Fund Level Analysis: LP approval thresholds, LP participation, LPAC considerations

How Does the Process Work?

■ Typical documentation

- Disclosure document
 - MNPI issues – information parity between buyers/sponsor/existing LPs
- Consent solicitation
- Partnership agreement/Amendments to existing LPA
- Purchase and Sale Agreement (Asset Sale)
- Merger Agreement (Merger)
- Assignment Agreement (Tender)

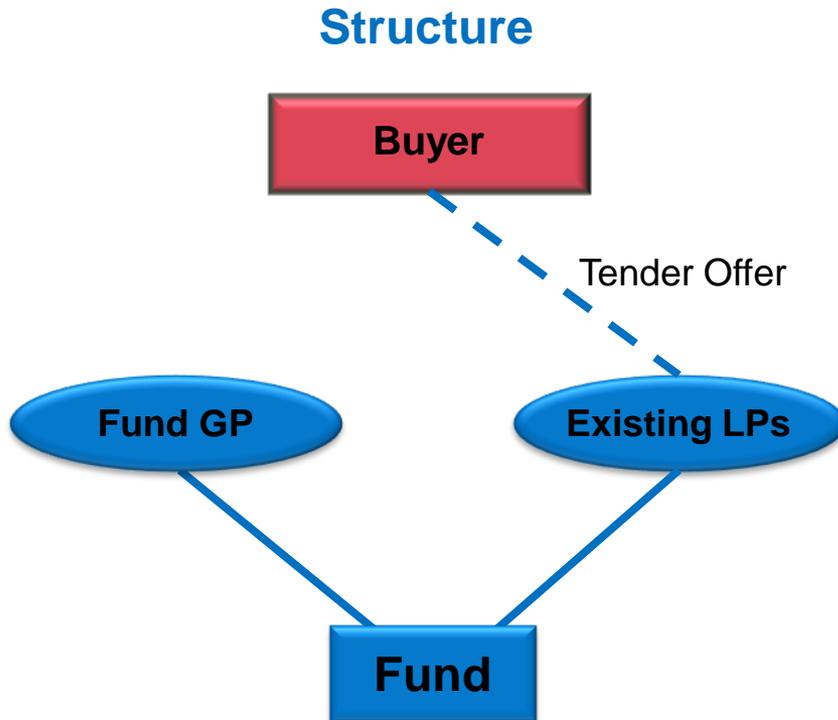
■ Syndication

- Often a lead buyer will close on transaction in the first instance
- Later syndicate out to smaller participants

Structures

- There are generally three ways for a fund to effect a restructuring transaction:
 - Tender offer
 - Asset transfer
 - Merger
- Which structure to select depends upon several key factors:
 - Change of control issues
 - Tax structuring
 - LP/LPAC approvals
 - Extent to which new terms will be established

Tender Offer Option



■ Considerations

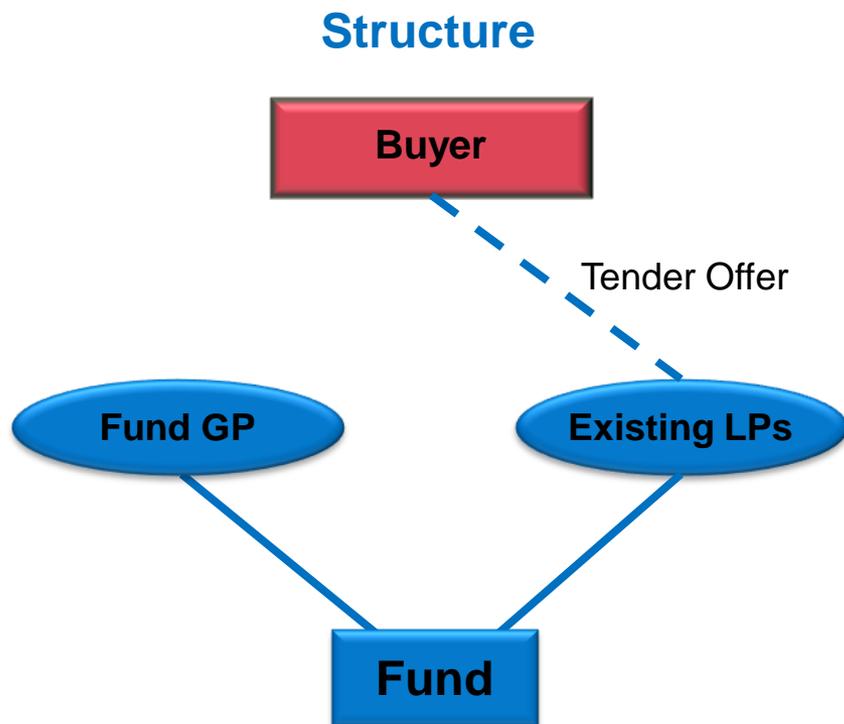
- **Structure:** Buyer will make an offer to purchase limited partnership interests from existing LPs. LPs can choose to sell or stay in fund. No movement of existing assets. Fund stays in place with buyer(s) as new LPs.
- **LP Approval:** No specific approval is needed unless amendments are made to LPA.
- **Partnership Agreement:** Partnership Agreements to remain in place unless amendments are made.
- **Change of Control:** This option should not (pending due diligence) have a high risk of change of control issues arising at the portfolio company level.
- **Post-Closing Ownership:** There is less certainty with respect to ownership due to variability of participation level of existing LPs.
- **Post-Closing Terms:** Fund terms can be varied by amendment, but subject to LP approval. Depends in large part on what percentage buyer acquires.

Tender Offer Option (Cont.)

■ Additional Considerations

- **Legal Requirements:** SEC tender offer rules (or comparable foreign rules) need to be complied with.
 - Offer must remain open for 20 business days.
 - Material changes to terms require re-opening offer for 10 business days
 - Transaction price must be “fixed”
 - See SEC release regarding “mini tender offers and partnership tender offers”

Tender Offer Option – Tax Considerations



■ Tax Considerations

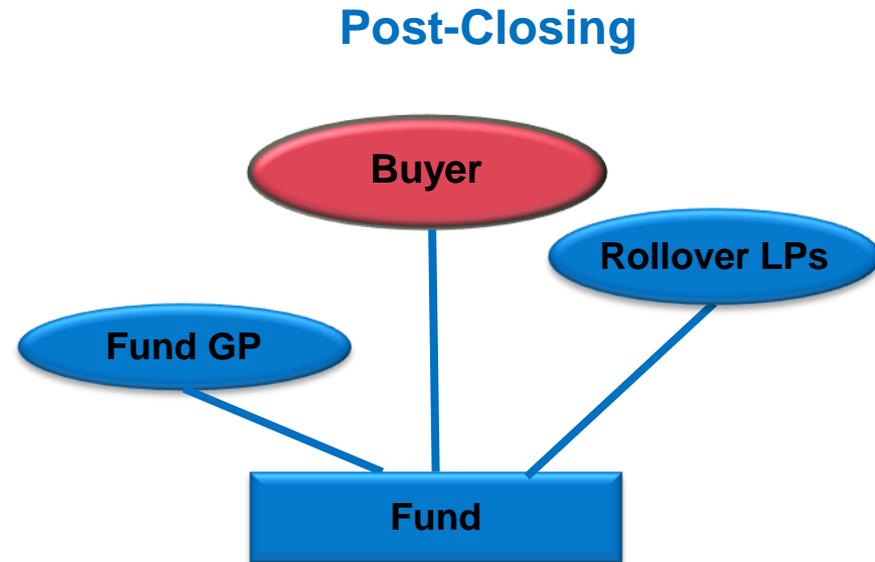
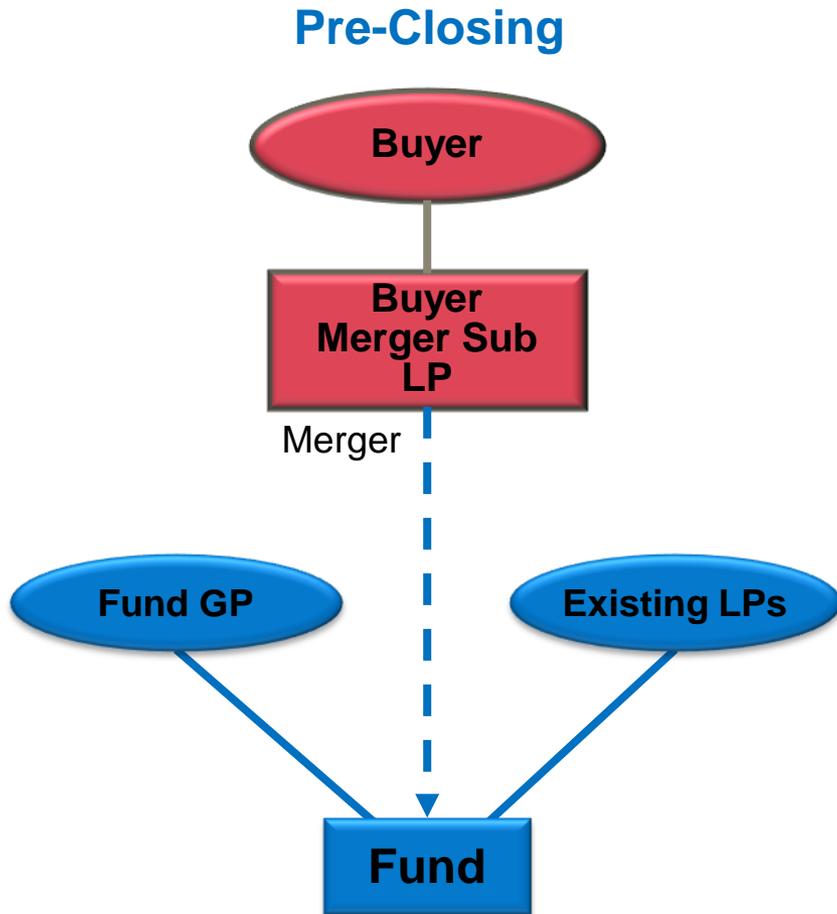
- **PTP Issues**

- An entity that would otherwise be classified as a partnership for U.S. tax purposes may nonetheless be classified as an association, taxable as a corporation, if it is publicly traded.
- GP's will insist on appropriate representations and warranties on PTP issues, may require an opinion in more nuanced circumstances
- Less of an issue for smaller funds with < 100 investors, can be significant monitoring issue for larger funds with numerous small investors
- 2% "lack of actual trading" safe harbor" may not be practical where a number of smaller investors transfer their interests in the same taxable year

- **Tax Basis Adjustments**

- Buyer will receive an outside basis equal to its purchase price in the Existing LP interest. However, inside basis will not be adjusted absent a 754 election.
- Unusual for funds to make 754 election, but where made, Buyer's share of the fund's inside basis may be adjusted to reflect "stepped-up" value equal to purchase price paid.
- If a fund's assets have decreased in value (generally, if (a) partnership's inside basis in assets exceeds FMV by \$250k or more, or (b) transferee partner would be allocated \$250k loss if partnership's assets were sold), downward inside basis adjustment is mandatory, unless the Fund is an electing investment partnership (EIP).

Merger Option



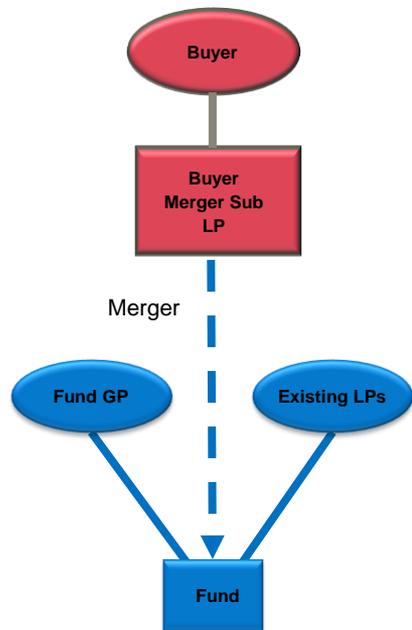
Buyer Merger Sub merges with and into Fund with Fund as surviving entity.

Merger Option (Cont.)

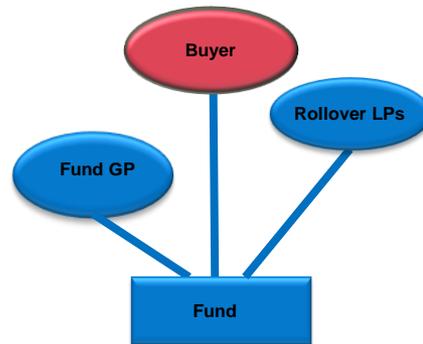
■ Considerations

- **Structure:** Buyer will set up a merger sub. Merger Sub will then merge with and into Fund with Fund as surviving entity. Similar to tender offer, no assets are transferred. Existing LPs given option to receive cash or retain interests in merged entity.
- **LP Approval:** Need to review partnership agreement for specific threshold and conflict of interest transaction approvals. In addition, law of Fund's domicile needs to be reviewed regarding legal requirements to effectuate merger.
- **Partnership Agreement:** Fund Partnership Agreement may be the surviving partnership agreement or a new partnership agreement may be put into place.
- **Change of Control:** Pending due diligence and further determination of structure detail, change of control risk is a potential issue.
- **Post-Closing Ownership:** The squeeze out nature of the transaction permits increased certainty for structure/governance/economics.

Merger Option – Tax Considerations



Buyer Merger Sub merges with and into Fund with Fund as surviving entity.

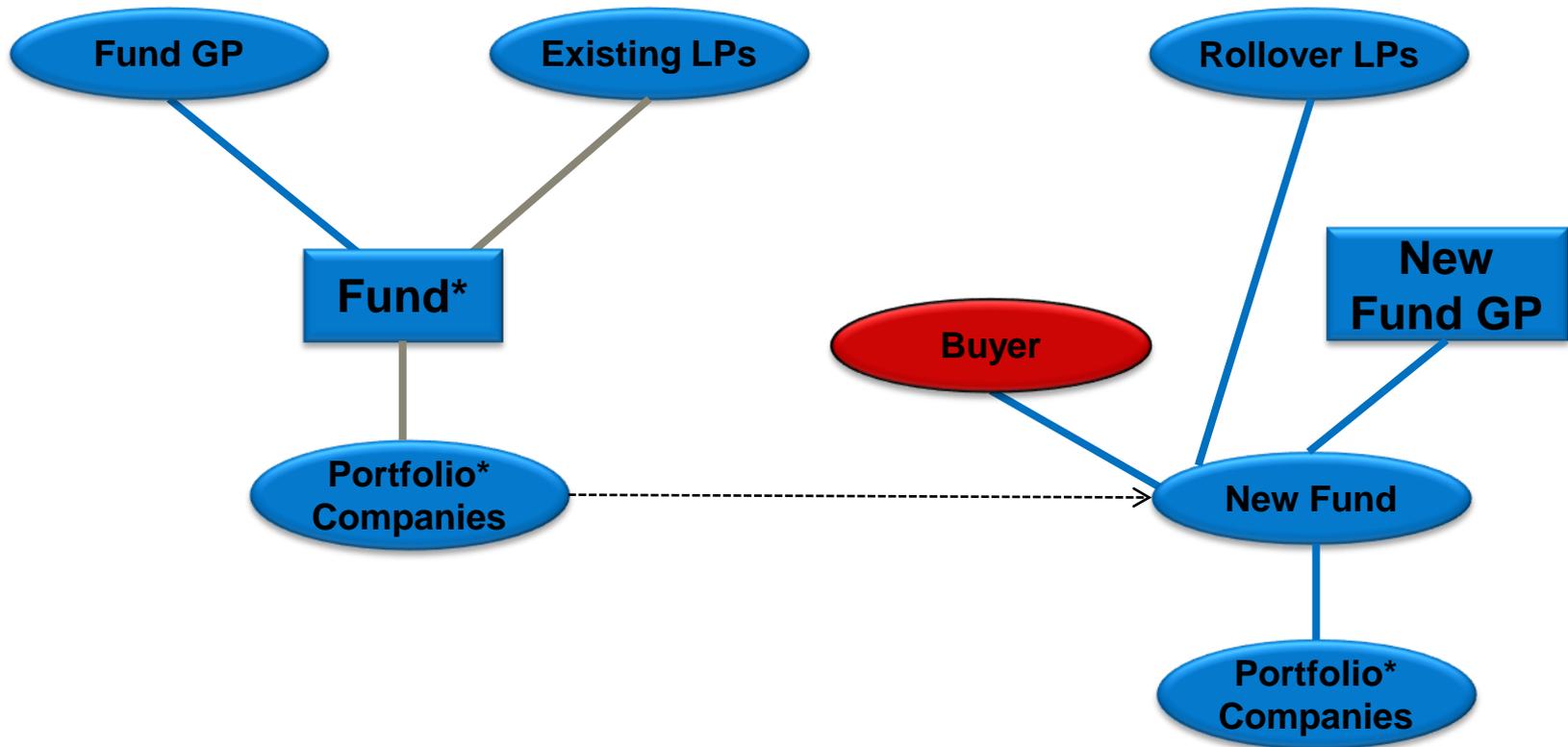


■ Tax Considerations

- Existing LPs and GP
 - No tax consequences for investors who roll-over and remain in place
 - To the extent cash received, gain or loss recognized
 - Long-term capital gains treatment may be available for taxable LPs who have held Fund interests for at least 12 months
 - Consider implication of new 3-year holding period for GP's carried interest or other profits interest holders
 - GP could negotiate for crystallized carry based on FMV at time of sale, in whole or in part, with no immediate taxation
- Buyer
 - Buyer will receive an outside basis equal to its cash invested into the Fund. However, inside basis will not be adjusted absent a 754 election (see discussion above).

Asset Transfer Option

Structure



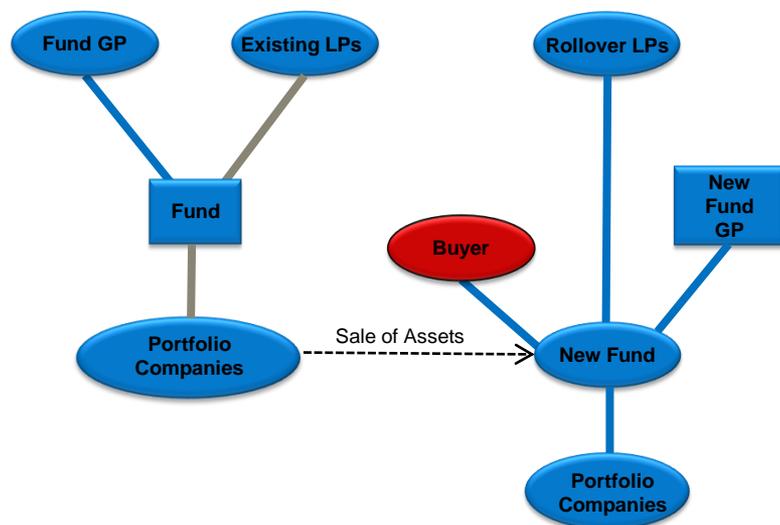
*Sale may be effected by sale of equity or assets of portfolio companies. Sale can be made at holdco levels to preserve existing tax structures.

Asset Transfer Option (Cont.)

■ Considerations

- **Structure:** Buyer and Sponsor set up new fund with Sponsor as GP/Investment Manager. Fund will then sell portfolio company/assets to Newco. Existing LPs will have option to receive cash or roll-over their Fund interests for interest in new fund.
- **LP Approval:** Need to review partnership agreements for specific threshold and conflict of interest transaction approvals. LPAC approval almost always required.
- **Partnership Agreement:** Terms of new fund as agreed by buyer and Sponsor and roll-over LPs.
- **Change of Control:** Likely to constitute change of control.

Asset Transfer Option – Tax Considerations



■ Tax Considerations

Structure: transaction could be structured as an asset sale for cash at Fund level (taxable for all investors) or a part-sale, part-rollover into a new Fund, where some investors desire to roll-over their equity interests on a tax-deferred basis

- **Existing LPs and GP:**

- May have option to receive cash in taxable sale or receive roll-over interests in new Fund on a tax-deferred basis.
- No taxable income for investors who roll-over and remain in place; gain is deferred
- To the extent cash received, gain or loss recognized
- Long-term capital gains treatment may be available for taxable LPs who have held Fund interests for at least 12 months
- Consider implication of new 3-year holding period for GP's carried interest or other profits interest holders
- GP could negotiate for crystallized carry based on FMV at time of sale, in whole or in part, with no immediate taxation

- **Buyer:**

- Buyer will receive an outside basis equal to its cash invested into the Fund. However, inside basis will not be adjusted absent a 754 election (see discussion above).

Additional Structural Considerations

■ SEC Advisers Act Registration

- If existing sponsor was relying on the venture capital exemption, that exemption may no longer be available post transaction

■ Co-Investments:

- Pricing dynamics between main fund and co-investment vehicles
- Co-investment vehicles may require separate approvals

■ Information Parity

- 10b-5 typically applies to consent solicitation materials
- Does sponsor possess material non-public information?
- Do selling LPs have same access to information as buyers?

■ Public positions

- Section 13 and Section 16 issues

Key negotiation points and issues

■ Valuation of Fund Investments

- GP Conflict of Interest - Wearing Buyer's and Seller's Hats
- Market Checks
- Fairness Opinions / Third-Party Valuations
- Role of Advisory Board

■ Fund life/term

- Tension in existing LP expectations for liquidity
 - PE investing is a long-term commitment
 - PE funds are not evergreen investment vehicles
- Will additional time to harvest investments achieve higher returns?

Key negotiation points and issues

■ GP Economics

- Management fees
 - Typically drop down over time, in particular after the end of a fund's investment period
 - Intended to cover GP's operating costs
 - Potential to place economic stress on GP if become too low
- Management fee offsets
 - Offsets for transaction fees, monitoring fees, directors fees, etc.
 - Historically less than 100%
 - Newer funds trending towards 100%
- Carried Interest
 - Typically 20%, but can range between 10-25% depending on fund type
 - European waterfall (full return of capital) vs. US waterfall
 - Tiered carry
- Preferred Return
- GP Clawback
- New Investor Bias towards alignment of GP with carry vs management fee
 - Tiered carry
 - Budget-based support for requested management fee

Key negotiation points and issues

■ Status Quo Option

- Economic status quo
- Extension of fund terms and other typical non “status-quo” changes

■ New “Dry-Powder”

- May be restricted to follow-on investments
- May include additional restrictions on new investments
- Treatment of rolling investors (both participation options and dilution) varies

Key negotiation points and issues

- Common LP Friendly New Terms (Non-Economic)
 - No-Fault Removal of the GP
 - Super-majority threshold
 - Honeymoon period
 - Strengthened Conflict of Interest Provisions
 - Increased detail in investor reporting
 - Increased detail in investor reporting
 - Vesting on new GP economics

Key negotiation points and issues

- Allocation of Transaction Liability/Indemnification Responsibility
 - Breaches of Representations and Warranties
 - Retained Liabilities
 - Potential GP Conflict with respect to enforcement of claims
 - Exactly who is the “seller”
 - Hold-backs
 - Escrows
 - “LP Clawback”
 - Third-party insurance

SEC's focus on private equity extends to fund restructurings

■ Igor Rozenblit – SuperReturn conference, June 2015

- “The secondary transaction [involves] a fund to which the manager owes a fiduciary duty and often benefits the manager itself because it keeps them in business and it provides additional fees. So we’re looking to see how fiduciary duty is executed in the context.”
- “Another thing we are looking for in that instance is offering fraud. The managers find themselves in a difficult position where they have to convince a buyer to buy a set of assets at a price and they have to convince a seller to sell the assets for a price. It’s all very stressful for the manager because if the assets don’t sell, a lot of times that’s the end of the manager. There’s a lot of opacity and they control all the information. That situation seems ripe for misinformation and offering fraud.”

SEC's focus on private equity extends to fund restructurings

- Marc Wyatt – “Private Equity: A Look Back and a Glimpse Ahead”, May 2015 speech
 - “The private equity industry has experienced strong growth in the past few years, but we all know that private equity markets are cyclical. Current levels of dry powder and transaction multiples make me worry that, at some point, the markets will start to recede and that the outgoing tide may reveal disturbing practices which will need to be addressed. Issues such as zombie advisers and fund restructurings may again come to the fore as we move through the business cycle.”

- Focus on “pre-commitment disclosure” – challenges when business realities and economic circumstances change

- SEC usually unmoved by fact that LPs are sophisticated investors

Advisers Act

- GP has affirmative duty of “utmost good faith, and full and fair disclosure of all material facts” as well as obligation to “employ reasonable care to avoid misleading” clients (SEC vs. Capital Gains Research Bureau)
- Rule 206(4)-8 – it is a “fraudulent, deceptive, or manipulative act, practice, or course of business” for any investment adviser to a pooled investment vehicle to:
 - Make any untrue statement of a material fact or to omit to state a material fact necessary to make the statements made, in the light of the circumstances under which they were made, not misleading, to any investor or prospective investor in the pooled investment vehicle; or
 - Otherwise engage in any act, practice, or course of business that is fraudulent, deceptive, or manipulative with respect to any investor or prospective investor in the pooled investment vehicle.

Key fiduciary / conflict considerations and likely areas of focus for SEC

- Overall fairness of transaction
- GP conflicts of interest
 - GP sitting on both sides of fund restructuring transaction
 - Management fee / carried interest
 - GP compensation creates conflict but necessary to properly incentivize management
- Terms offered to non-selling LPs
- Valuation / pricing
 - Whether a third-party advisor was engaged to conduct competitive auction
 - Valuation report or fairness opinion

Key fiduciary / conflict considerations and likely areas of focus for SEC

- Allocation of fees and expenses
 - Who bears costs associated with transaction, e.g., fees of external advisors and intermediaries
- Quality of disclosure provided to LPs
 - Potential alternatives to restructuring
 - Ability to conduct own due diligence
 - Equal access to information
- Approval process
 - LPAC approval – whether sufficient authority under LPA; whether LPAC members themselves may be conflicted
 - LP approval

Transfers of PE Fund Interests – Tax Withholding Obligations

- Under new Section 1446(f) of the Internal Revenue Code, upon disposition of a partnership interest, a transferee must withhold 10% of the “amount realized” if –
 - Transferor is foreign person;
 - Transferor has gain on the disposition; and
 - any portion of the gain is treated as effectively connected with a U.S. trade or business (“ECI”) to transferor under new § 864(c)(8)
- IRS has suspended this withholding obligation on dispositions of publicly traded partnership interests, as well as for certain transfers specified in IRS guidance:
 - Transferor provides certificate that no gain recognized on transfer;
 - Transferor provides affidavit that less than 25% of its income in three prior years was ECI;
 - Partnership provides affidavit that if it sold all of its assets for fair value, ECI would represent less than 25% of gain (unlikely that most sponsors will provide); or
 - Transfer occurs via non-recognition transaction (e.g. restructuring among affiliated entities without triggering gain).

Transfers of PE Fund Interests – Tax Withholding Obligations (Cont.)

- Under the Foreign Investment Real Property Tax Act (“FIRPTA”), a similar 15% withholding obligation will be imposed on a transferee if the transferor disposes of a U.S. real property interest (a “USRPI”). A partnership interest (e.g. an LP interest) will be treated as a USRPI if 50% or more of the value of the partnership’s gross assets consist of USRPIs, and 90% or more of the value of the partnership’s gross assets consists of USRPIs plus cash or cash equivalents.
 - A transferee is not required to withhold under Section 1445 if (i) the transferor is not a non-U.S. person and provides a certificate to this effect, (ii) the Internal Revenue Service certifies that no withholding is required by the transferee, or (ii) the partnership provides a certificate, signed by the general partner under penalties of perjury, certifying that the 50/90 percent thresholds mentioned above are not met.
- Recommendation: A buyer of an LP interest should ensure that the transfer agreement contains language obligating the transferor and/or the GP to deliver the requisite ECI and FIRPTA withholding certificate, which should include language certifying that the transfer is exempt from withholding under one of exceptions above (or, if necessary, that relevant taxes will be withheld).
 - GP should ensure that it does not bear residual liability if transferor fails to withhold appropriate amounts of taxes from transferee.

Other Tax Considerations in PE Fund Restructurings

■ LP Issues

- A purchaser steps into the shoes of a seller in a secondary transaction, and therefore a purchaser inherits the investment tax structure (and any tax liabilities resulting from it) at both fund and portfolio company level.
- Withholding
- Allocation of taxes for year of transfer

■ GP Issues

- Transfer of Profits Interests and staying within Rev. Proc. 93-27 Two-Year “Safe Harbor”
- Associated Valuation Concerns
- 3-Year Holding Period for carried interest
- Sales of management fee streams and character issues

■ Fund Issues

- Non-U.S. / state / local taxes
- Transfer taxes (real estate / infrastructure / energy funds)

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Michael Belsley

Michael Belsley is a partner in the private equity and investment funds practice groups at Kirkland & Ellis LLP. Michael regularly represents fund sponsors, buyers and sellers, as well as market intermediaries, in their private equity secondary market activities. His secondary market experience includes a wide variety of transactions, including fund restructurings, fund recapitalisations, captive fund spin-outs, traditional secondary portfolio sales and a wide variety of structured secondary transactions.

Aaron Schlaphoff

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Stephen Butler

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